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THE PROCEDURE OF CONTEMPORARY RAILROAD REORGANIZATION[1]

The procedure followed at the present time in effecting the reorganization of an American railway system has developed through a series of precedents, each one of which was established originally more through accident than forethought. Ordinarily a fundamentally important mode of procedure, in financial as well as other social affairs, results from a slow and tempered growth of precedents, all of which are firmly rooted in the common or the statutory law, and all of which are constantly balanced off against contemporary social opinion. The history of the organization of the business corporation, the history of the public franchise, the history of the practice of corporate taxation, are all illustrations of the orderly and well regulated development of a body of well considered precedents, consistent at all times with the law and public opinion. Not so the present practices governing the reorganization of railways. They have arisen through immediate necessities; they have come into existence at times when any action, legal or illegal, impetuous or reflective, was better than no action.

Four separate and often antagonistic sets of motives govern the procedure to be followed in the reorganization of a railroad. The most important and usually the least apparent is concerned with the human or psychological elements. Most writers on finance, taking their promptings from published circulars and reports, forget the interplay of human motives, ambitions, antagonisms, and friendships that underlie every financial episode of importance. A railroad is reorganized by men, not puppets; its officers, its creditors, its security holders, the attorneys and the judges are not mere thinking machines, but ordinary men, subject to human emotions and weaknesses. First, then, the procedure must be such as to allay, not aggravate, the friction incident to the conflict of personalities. The second set of motives governing reorganization procedure is economic. Leases must be continued or abrogated, branch lines rebuilt or closed, rights enforced or surrendered, in

[1] This article follows one on "The Theory of Railroad Reorganization," published in the December, 1918, number of the AMERICAN ECONOMIC REVIEW (vol. VIII), p. 774.

accordance with the single question—Is it profitable? No railroad can be permanently successful and serve the public well which does not pay its operating expenses, including fair wages to its employees, with adequate upkeep of its plant, and in addition a fair rate of return on the invested capital. And the reorganization procedure must recognize this simple economic imperative. The third set of controlling motives is legal and judicial. Experienced students of legal practice have worked out certain more or less clearly defined lines of orderly procedure. Some of these lines of procedure have been prescribed by the courts, others are merely tolerated by the courts because they facilitate the regular course of the reorganization, and others, arising from the ingenuity of lawyers, are followed until some court decision condemns them. Lawyers are apt to exaggerate their own importance and the significance of their legal machinery in determining the form and details of reorganization procedure, forgetful that a reorganization is primarily an adjustment of human motives and economic conditions, circumscribed, rather than determined by the law.[2] The fourth set of motives—only recently of importance—is the rulings and requirements of public service commissions. In theory, at least, the public service commission requires that the course of the reorganization shall not jeopardize any of the rights of the public. The present orderly procedure of a railroad reorganization has been built up from the interplay of these four sets of motives.

The chronological steps in the procedure are strikingly uniform. The first sign of impending trouble is the decline in the railroad's credit. This is usually a matter of common knowledge in financial circles. The weakness will have shown itself in at least three direc-

2 As stated in another connection, "One may hazard the guess that there is no field of modern economic relations where legal phrases count for as little as in railroad reorganization; and as time passes their significance seems to become less." A. S. Dewing in the American Economic Review, vol. VI (1916), p. 907. The earliest clear acknowledgment by the judiciary itself of this fact, that I can find, is a statement by Chief Justice Waite some twenty-five years ago: "It rarely happens in the United States that foreclosures of railway mortgages are anything else than the machinery by which arrangements between creditors and other parties in interest are carried into effect." Can. So. Ry. Co. *v.* Gebhard, 109 U. S. 539 (1883). It is noteworthy that this admission that legal steps constitute the "machinery" for accomplishing economic ends, is quoted with approval by Cravath in his essay on the legal procedure (n. 11). On the other hand, lawyers and judges would give the impression that legal procedure embraces about all there is to a reorganization.

tions in the months preceding a railway failure, and an astute student of railways would probably discover other indications of falling credit. The company's securities have declined in quoted value on the exchanges where they are dealt in, the company itself has paid increasing rates of interest and has borrowed on rapidly maturing, miscellaneously secured notes, and the general property of the company, particularly its rolling stock, has been allowed to depreciate. For a considerable period the earnings also will have been declining, but invariably this decline will have been attributed to transitory and superficial causes rather than to any cause sufficiently deep-seated or permanent to suggest an impending crisis. The three signs of weakness alluded to above, accompanying or following steadily failing net earnings, are prophetic of failure.

The exact time at which the failure of a railroad is publicly acknowledged is largely at the discretion of the directors. The explicit failure of an industrial company may come suddenly, as the immediate consequence of a labor strike, a panic, or a bank failure; but a railway failure, invariably due to deep-seated, slow acting causes, may be postponed or quickened at the discretion of those in immediate control. At all events, when the financial and operating conditions of the road reach such a pass that a crisis seems inevitable to the management, one or both of two steps are taken—the organization of protective committees and the petition for the appointment of a receiver. Sometimes committees close to the management are formed before failure has reached a crucial stage, one of their avowed purposes being to prevent or forestall receivership proceedings;[3] and sometimes receivership proceedings are brought suddenly, and almost at the last moment, before the management has an opportunity to organize a "stockholders' committee." Thus no general rule can be laid down covering the order of these two events, but the public acknowledgment of financial failure is indicated if one or the other or both of them occur.

The organization of protective committees is more important than the receivership proceedings, the latter being a legal formality now often dispensed with. The committees arise from approximately five different sources. Invariably there is a stockholders' committee, usually dominated by the old directors of the road.

[3] Protective committees for the Missouri Pacific Railway were organized in 1914 in the hope of effecting a "readjustment" (a delicate word for reorganization), and the petition for receivership was not made until August, 1915, when it was found that this "readjustment" could not be effected.

This committee acts on the defensive; throughout the whole course of the reorganization proceedings the stockholders' committee is engaged in explaining and justifying the past management on the one hand, and haggling with the other committees in regard to the extent of the sacrifices which the old stockholders must undergo in order to regain the control of the road. The other four types of committees are representative of bondholders. There is usually a committee or committees of junior bondholders, of the senior bondholders, of branch and divisional line bondholders, and of the bondholders of subsidiary lines or terminal properties controlled through leases or operating contracts. These committees of bondholders are formed and dominated by the investment banking houses which were responsible for the original sale of the bonds to the public; if the bonds were distributed long ago, prominent trust companies or life insurance companies may assume the guiding hand.

The junior bondholders' committee or committees will stand antagonistic to the committee of stockholders. They will insist that the junior bondholders shall endure as little sacrifice as possible, and that the full brunt of the burden of reorganization shall fall on the stockholders. The committees of senior, branch and leased line bondholders will assume throughout an attitude of watchful waiting. In the majority of cases, especially if the property covered by their liens is strategically important for the unity of the railway system, they will be called upon to take little part in the reorganization. If, as is the case in comprehensive reorganizations, they are required to fund their bonds under new first and general mortgages, they will be able to prescribe the conditions which the junior bondholders and stockholders must accept.

In the older reorganizations, there were more committees than at present.[4] The tendency now is to have few committees and to have these few thoroughly representative and endowed with

[4] For example, before the Union Pacific reorganization had been accomplished, no less than fifteen committees had been formed. There were committees representing the first mortgage bonds, the consolidated mortgage bonds, the collateral trust 5's, the collateral trust 4½'s, the Oregon Railway and Navigation Consolidated bonds, the Dutch bondholders, two committees each for the Kansas Pacific consolidated bonds and the Denver Extension bonds, a joint committee of foreign bondholders, and various committees representing branch line bonds. See S. Daggett, *Railroad Reorganization* (Harvard Economic Studies, vol. IV, 1908), ch. VII.

considerable power.[5] It facilitates matters very much if the important committees agree among themselves over the formation of a general reorganization committee upon which representatives of the different committees serve. Not only does such a general committee tend to ease the tension and remove misunderstandings, but it makes possible a unified and far-sighted policy of investigation during the period pending the reorganzation, and it does away with unnecessary public discussion and rankling over successive plans of reorganization. Such a general committee assumes the burden of preparing a plan of reorganization in the interest, ostensibly at least, of impartial justice.

While the formation of committees is entirely a matter of invitation and mutual agreement, there are very distinct responsibilities attached to membership on important reorganization committees. Formerly membership was more or less a matter of accident, or at most a privilege attaching itself to the ownership of a considerable block of securities the value of which had been placed in jeopardy by the financial crisis of the road. In consequence, members of important committees were often men of little intelligence or familiarity with railroad finance; quite generally they had no standing beyond their own cities. At the present time, however, the custom is to have well known, highly responsible men serve on the various reorganization committees; men are chosen more because of their national standing in banking and railway circles, their integrity and proved wisdom and financial experience, than because of ownership or control of securities. And such a personnel is wise. Railway reorganization requires highly expert and specialized knowledge. The greater the number of reorganization committees a man has served upon, the greater is his value, and after a time he acquires a kind of national reputation for skill in this particular field. He will not be responsible for a reorganization plan likely to jeopardize his reputation for honesty and impartiality. Moreover, the plan of reorganization finally agreed upon by men of acknowledged responsibility and

[5]The practice is becoming clear, as a whole, for as many classes of debt and security holders to organize themselves into committees as there are substantial equitable interests in the corporation's property, but no more than is absolutely necessary. A duplication of committees, representing the same interest and differing only in personnel, is frowned on by the courts and achieves no other end than a break on the course of the reorganization. The effectiveness and responsibility of committees will vary directly as the authority vested in them.

expertness will receive public approval much more readily than a plan advanced by less well known men. This general tendency to have a reorganization supervised by highly responsible experts, rather than by holders of large amounts of securities, is in general accord with the tacit acknowledgment that a railroad reorganization is a public and not a private matter.[6]

As soon as each committee is formed, it organizes itself, selecting one member to act as chairman.[7] A legal counsel is chosen and some trust company is asked to receive the deposit of securities under a general agreement according to the terms of which the committee is empowered by those depositing their securities to act for them and in their stead. The powers conferred on the committee by this deposit agreement are very general, and the tendency of recent years is to enlarge them. In fact, it may be said that the committees are trustees for the depositors under their agreement acting with all the powers possessed by the owners separately and with the additional powers that their majority control involves.[8] We shall return presently to the procedure in connection with the formation and organization of committees.

6 From the above account, it should not be inferred that reorganization committees "constitute themselves," as it were, out of a clear sky. Ordinarily some banking house has been the acknowledged sponsor for the railroad, through the sale of large blocks of bonds. This banking house will "invite" prominent bankers to become members, thinking by so doing to give added respectability to their committee. The directors, similarly, will "invite" other prominent bankers to serve on their stockholders' committee.

7 Great care must be taken that the committee members, particularly the chairman, shall be free from partiality, else the court may permit a duplication of committees, thus impeding the reorganization. In the recent reorganization of the Chicago, Rock Island and Pacific Railway, the president of the trust company, which was trustee of the bonds upon which the foreclosure suit was based, was chairman of the bondholders' committee. The court considered this a dual position, and permitted a minority bondholders' committee to intervene, thus creating unfortunate complications.—*Central Trust Co.* v. *C. R. I. & P. R.R. Co.*, 218 Fed. 336 (1914).

8 The legal powers of reorganization committees acting under modern deposit agreements have been briefly summarized in a lecture before the Harvard School of Administration by the late Adrian H. Joline, than whom there have been few abler masters of reorganization procedure.

"There is conferred upon the Committee all the rights and powers of owners of the deposited securities and full discretion as to the methods of carrying out the agreement, with power to construe it.

"The Committee is usually authorized to maintain necessary suits; to sell the deposited securities under certain restrictions appropriate to the case; to put in motion suits to foreclose mortgages; to purchase the property at any

The character and the significance of the legal aspects of a reorganization depend, very largely, on whether or not a receiver is appointed to administer the railroad during the period between the financial crisis and the final consummation of the reorganization. This, in its turn, depends on whether or not there is likely to be acrimonious and prolonged dispute among the various security holders, or a recalcitrant group of security holders, likely to impede or frustrate an amicable settlement of conflicting interests. If the failure is very serious, thus entailing large losses to all concerned, or if it involves a large railway embodying many conflicting interests, or if there are burdensome leases and contracts which must be abrogated at all hazards, then receivership proceedings are necessary. Through a judicial sale of the bankrupt railroad's property, the court can either force a recalcitrant minority to accept what it considers a just reorganization plan or it may extinguish the interests of the minority. But if the various security holders can arrange a plan of reorganization among themselves, without resort to the machinery of the courts, the whole reorganization can be carried out with little outward formality. A court receivership is expensive, destructive of "goodwill" values, hurtful to the road's general credit, and places in jeopardy valuable franchises which may have been granted years before when legislatures and commissions observed a beneficent liberality toward railroads. A reorganization consummated without compulsory pressure exerted by the courts through judicial sale, even though a receiver be appointed at some stage in the proceedings, is called *voluntary*; one consummated through the coercive authority of the court, represented by a judicial sale of the old railroad and the organization of a new railroad corpora-

sale, using the deposited securities so far as may be in payment of the purchase price, with power to borrow money necessary to complete the payment and to assign the bid or otherwise use the property to secure repayment of the sums borrowed; and to convey the property to a new company or otherwise dispose of it subject to the conditions set forth in the agreement.

"The Committee generally has power granted to it to limit the time for making deposits; to employ counsel and assistants; to receive reasonable compensation, sometimes limited to a certain percentage on the face value of the deposited securities, and to have its expenses paid subject usually to a like limitation. The Committee is frequently authorized to borrow money and to pledge the deposited securities as collateral for the loan, for the purposes of the agreement, the protection of the depositors, the preservation of the property, or to defray expenses.

"Depositors incur no personal liability for expenses, but the deposited securities constitute the fund for that purpose."—Lectures, p. 12.

tion, is called *involuntary*.[9] The vast majority of railroad reorganizations are involuntary, and follow a court receivership, although from time to time voluntary reorganizations have been attempted for large railway systems, sometimes successfully.[10]

In the vast majority of cases, the first step in the legal procedure of a railroad reorganization is the appointment of a receiver by a court of equity.[11] It cannot, however, be stated that

9 There is possible a kind of threefold classification depending on legal sanctions:

Voluntary, without receivership: when failure is due to temporary causes, that operate relatively slowly, or the difficulties are easily adjusted by the security holders. Common among industrials, local public utilities and small railroads. Rare for large railway systems. The Atchison reorganization of 1889.

Voluntary, with receivership: when failure is due to temporary causes, operating quickly, or when valuable property with large equities meets sudden disaster. Very common among industrials of all classes. The common form of voluntary reorganization among railroads. The Baltimore and Ohio of 1899.

Involuntary, with receivership: the ordinary form. Almost universal among railroads and commonest among industrials and local public utilities.

10 In the summer of 1915 a voluntary reorganization, without receivership, was attempted for the Missouri Pacific Railway. As a voluntary reorganization it was unprecedented in the history of railroad finance for the radical sacrifices demanded by the branch line and junior bondholders. To accomplish the coöperation of these bondholders and of the assessed stockholders, the committees pointed out that a receivership, entailing much added expense, would be necessary unless the security holders willingly consented. They refused. A receivership followed, and under the authority of the courts the identical plan of reorganization was forced upon the security holders at greatly increased expense to the corporation.

On the other hand, the great reorganization of the Baltimore and Ohio Railroad in 1899, entailing considerable sacrifice, was finally consummated without judicial pressure. This was, on the whole, the most remarkable case of a voluntary reorganization.

Out of over five hundred railroad organizations between 1884 and 1900, examined by Meany (*Poor's Manual of Railroads,* 1900), sixteen were voluntary. Since 1900 about a tenth of those capital readjustments, sufficiently comprehensive to be called reorganizations, have been of the voluntary type. There have been numerous "readjustments" accomplished without receivership or pressure upon the security holders, but they cannot be considered as substantial reorganizations.

11 The appointment of a receiver to conserve property is one of the so-called "extraordinary remedies" allotted by our Anglo-Saxon law to the equity courts. Such courts "will not lend their aid by the appointment of receivers when the persons seeking the relief have ample redress by the usual course of proceedings at law, or when the law affords any other safe or expedient remedy."—J. L. High, *A Treatise on the Law of Receivers,* p. 16.

The court of equity can exercise its discretion as to whether it will appoint

all railway receivership proceedings arise from anticipated or actual failure.[12] Historically the current procedure has developed by a slow evolution. It represents the gradual transition from a complex, haphazard procedure to enforce railway obliga-

the receiver.—*Mil. and Min. R. R. Co.* v. *Soutter,* 2 Wall. 510 (1864). Also 8 Biss. 247.

The position of a receiver is very concisely described by Baldwin, J.: "By means of the appointment of a receiver, a court of equity takes possession of the property which is the subject of the suit, preserves it from waste or destruction, secures and collects the proceeds or profits, and ultimately disposes of them according to the rights and priorities of those entitled. . . . The receiver appointed is the officer and representative of the court, subject to its order, accountable in such manner and to such persons as the court may direct, and having in his character of receiver no personal interest but that arising out of his responsibility for the correct and faithful discharge of his duties."—*Beverly* v. *Brooke,* 4 Grat. 208.

The duties of receivers for public service corporations are briefly described by Judge Lacombe: "Their (the receivers') sole functions are to hold the property intact, operating it as efficiently for the public service as their resources will permit, to ascertain the liabilities, to marshal the assets and eventually........to sell it to the best advantage and to apply the proceeds rateably to the payment of the liabilities."—*Penn St. Co.* v. *N. Y. C. Ry. Co.,* 157 Fed. 442 (1907).

For brief but comprehensive accounts of the appointment and duties of receivers see the two essays by J. Byrne and P. D. Cravath in a book entitled *Some Legal Phases of Corporate Financing Reorganization and Regulation* (Macmillan, 1917), being addresses delivered in 1916 at the instance of the Association of the Bar of the City of New York by distinguished practicing lawyers. These two essays, together with the lectures by the late Adrian H. Joline at Harvard, are the best available brief summaries of legal procedure of a modern corporate reorganization. The book of essays will be frequently referred to under the title of *Some Legal Phases,* etc.

There have been a large number of periodical articles dealing with railroad receiverships: H. C. Caldwell, "Railroad Receiverships in Federal Courts," *American Law Review,* vol. 30 (1895), p. 161; A. S. Bennett, "Railroad Receiverships," "Oregon Bar Association Proceedings, vol. VI (1886), p. 47; J. F. Crowell, "Railway Receiverships in the United States," *Yale Review,* vol. 7 (1898), p. 319; H. H. Swain, *Economic Aspects of Railroad Receiverships,* Economic Studies, vol. 3 (Am. Econ. Assoc., 1898), p. 53; S. Daggett, "Recent Railroad Failures and Reorganizations," *Quart. Journ. Econ.,* vol. 32 (May, 1918), p. 446. Special articles will be referred to under special topics. For general works see W. A. Alderson, *A Practical Treatise on the Law of Receivers;* J. L. High, *A Treatise on the Law of Receivers;* S. W. Jones, *A Treatise on the Law of Insolvent and Failing Corporations.*

12 In the first place, especially of recent years, receivership proceedings have been instituted or threatened by state or federal officers for alleged violation of the "Sherman anti-trust" act of 1890.

The number of receiverships resulting from dissensions, disputes, and

tions, current fifty years ago, to the relatively simple and orderly procedure of the present time.

In the earlier years, roughly, before the panic of 1873, corporate mortgages were construed literally. In case of a default in bond interest the trustee of the mortgage might acquire possession and management of the railway property, as the strict construction of the mortgage instrument permitted,[13] or a receiver might

intercorporate intrigues are legion. It was alleged that the Cincinnati and Eastern Railway went into the hands of receivers as part of the consummation of a plan to secure the road for less than its value.—*Ry. Age,* vol. VIII, p. 596. See also *F. L. T. Co.* v. *N. Y. and Nor. Ry. Co.,* 150 N. Y. 410 (1896). Some stockholders of the Ohio and Mississippi Railroad declared that its collapse in 1876 and receivership, was part of a concerted plan on the part of the Baltimore and Ohio Railroad to secure control.—*Chicago Railway Review,* vol. 14, p. 29; *Commercial and Financial Chronicle,* vol. 22, p. 526; vol. 16, p. 392. Probably the real cause was the excessive and unwarranted cost of building the Louisville branch. Receivers were appointed for the Cincinnati, New Orleans and Pacific Railway in 1893 in order to protect the road from liability for stock fraudulently issued by a former secretary.—J. H. Hollander, *The Cincinnati Southern,* Johns Hopkins University Studies, vol. 12 (1894), p. 1. In 1904 the Eastern Ohio Traction Company went into the hands of receivers because of the fear of damage suits resulting from a wreck on the Chagrin Falls branch. Receivers have been appointed in several cases because of controversies over leases as in the case of the Eastern Railroad of New Hampshire in 1877, and the Denver and Rio Grande in 1879. Instances also exist where a receiver has been appointed to settle controversies existing between opposing interests.

Swain gives instructive instances among early receiverships of exceptions to the rule that failure is the universal condition of receivership. The Cleveland, Delphos and Saint Louis Railroad was placed in the hands of receivers in 1884 and the Tennessee Central in 1895 in order to complete construction. The directors sought receivership for the Hutchinson and Southern in 1893 to transfer control from a county to a federal court.—Swain, *Econ. Aspects,* etc., pp. 90, 94.

In recent corporate history the Kansas Natural Gas Company was thrown into the hands of federal court receivers in 1912 to protect the company from what was regarded as the unlawful demands by state and municipal authorities, the federal court being considered able to prevent the sale of gas at less than cost. In 1911 the La Crosse Water Power Company was placed in receivers' hands to protect the company from damage suits caused by inability of the company to deliver current contracted for, on account of low water and the breaking of dykes.

13 On default the bondholder or his trustee awaited the period of grace, from thirty days to six months or even longer, and then began a foreclosure suit. In the absence of a receiver, the trustee of the bonds would assume the management of the railway. Notable case, Hartford, Providence and Fishkill Railroad.—*Chronicle,* vol. 22, p. 304. In rare instances, this action has actually been preferred by the court to the appointment of a receiver on the ground

be appointed at the instance of an antagonistic creditor.[14] The details of the procedure were distinctly matters of accident; the only certain thing being a variety of suits and countersuits all based on the desire of some faction to gain a temporary advantage through legal process.

The first period ended, and what we might call the second period of railroad receivership procedure began, with the failure of the Wabash Railway in 1884.[15] This important failure and the resulting reorganization was epoch-making in many respects,[16] but in none more than in the procedure by which it passed into the hands of the court. It was well known at the time that the Wabash system was unstable financially, but there had been no specific failure to meet any of its obligations. Yet, just before the in-

that less harm would be done to all the parties concerned. (*Tysen* v. *Wabash R. R.*, 8 Biss. 247.) But, owing to the variety of mortgages and the divergence of interests, this mode of procedure was cumbersome and prolific of disputes. Furthermore, with the growing consciousness that railroads were public enterprises, the courts were at first reluctant and later refused to extend to the mortgage trustees the full power the letter of their mortgage instruments implied, so that the trustees found their management hampered. For brief discussions of trustee management and the difficulties involved, see C. Barrett, "Dangers to Bondholders," etc., *Ry. Gaz.*, vol. 11 (1879), p. 385; J. F. Crowell, "Railway Receiverships in the United States," *Yale Rev.*, vol. 7 (1898), p. 327; Cleveland and Powell, *Railroad Finance* (1912), p. 230; W. Z. Ripley, *Railroads: Finance and Organization* (1915), p. 384.

14 In these early railroad receiverships, there was invariably an actual, not merely fictitious, opposition between the parties praying for the appointment of a receiver and the answer by the railroad's attorneys. The action was then, as now, usually initiated by a creditor's bill, claiming that the means for satisfying the creditor's claim was in jeopardy. This action by a creditor might or might not be a part of a contemporaneous action by a mortgage trustee seeking to assume the control and operation of the railway property. At all events, an officer of the corporation ordinarily appeared in honest opposition to the proceedings, and, as a result of the evidence presented by both sides of the controversy, the court obtained some inkling of the truth.

15 Crowell believes that the modern doctrine of railway receivership proceedings—in which the railroad itself may be an active or passive participant in placing itself under the administration of the court—"received its earliest formulation in the South." He cites as a leading case *Meyer* v. *Johnston*, 53 Ala. 264 (1875). This case contains an elaborate discussion of the rights of a court of equity in appointing seniors at the request of stockholders. See also 18 Grattan 819. Unquestionably the principle had been tacitly admitted in certain courts before its explicit acknowledgment in the Wabash case. See also L. A. Jones, "Receivers of Railways," *Southern Law Review*, vol. 4 (1878), p. 18.

16 See outline of this reorganization in previous article of this series, Am. Econ. Rev., vol. 8 (Dec., 1918), pp. 785-787.

evitable default on one of its thirty-odd mortgages, the officials of the road appeared before the federal court, and asked, on the petition of the road itself, that receivers be appointed. "If the lines," the petition reads, "of the road are broken up and the fragments thereof placed in the hands of various receivers, and the rolling stock, materials and supplies seized and scattered abroad, the result would be irreparable injury and damage to all persons having any interest in said line of road." The petition was granted. A corporation had placed itself in the hands of receivers. The action was heralded by all students of law as revolutionary and establishing a new interpretation of the theory of railroad receiverships. Yet the action of the federal judge was fully sustained by the United States Supreme Court.[17] Occurring

[17] *Wabash, St. Louis and Pacific Ry. Co.* v. *Central Trust Co.,* 22 Fed. 138 (1884); *Quincy, Miss. and Pac. R. R.* v. *Humphreys,* 145 U. S. 82 (1892); *St. Joseph and St. Louis R. R.* v. *Humphreys* 145 U. S. 105 (1892).

At that time the whole Wabash system consisted of over fifty subsidiary parts; it extended into six states. The federal justice who made the revolutionary decision saw fit later to defend his action as follows: "It was an application by the corporation itself, concerning which a great deal of comment has been made elsewhere . . . I hesitated. I found that Judge Shipman, a very learned and able judge, had gone over *in extenso* that class of thought. After further consideration with respect thereto, I reached the conclusion that his views were correct, to wit: Here is a vast system, extending through many states and many judicial districts. A default, it was certain, would be made in a few days. What should be done? The interests of all concerned required that some judicial action should be had for the conservation of those interests—stockholders, bondholders, creditors at large."—29 Fed. 623 (1886).

Chief Justice Fuller himself quotes the words of one of the attorneys that the bill was "without precedent" (145 U. S. 95), yet approved the principle on the ground of public policy. "We have seen," he said, "that the theory of this bill was that an insolvent railroad corporation may, in the public interest, and for the benefit of all its various creditors, surrender its property to a court of equity, to be preserved and kept in operation until it may be disposed of according to the several private rights concerned."—*St. Joseph and St. Louis R. R. Co.* v. *Humphreys,* 145 U. S. 113 (1892).

Notwithstanding, however, the explicit approval by the United States Supreme Court the doctrine was condemned by various state courts on the previously recognized ground that the petition for the appointment of a receiver must represent an "actual controversy." Such a petition (as in the Wabash case), said the Missouri supreme court, "is simply a petition by a debtor for the appointment of a receiver to manage and carry on its business, so that its creditors cannot enforce their legal rights in the courts of the country. . . . The filing of that petition no more instituted an actual controversy between contending suitors than would the filing of the Lord's Prayer. It laid no foundation whatever for the exercise of the jurisdiction of the court

as this did, in the period just before the many railway receiverships of the nineties, it established the practice of the so-called "friendly" or consent receivership for large railway corporations; and the procedure was soon applied to local utilities[18] and later to industrials.[19] These consent receiverships are now the rule for all large corporate failures.[20] Brushing aside exceptional con-

to appoint a receiver."—*State re Merriam* v. *Ross*, 122. Mo. 435 (1894). Nevertheless, these outcries on the part of state courts have availed little, and receivership petitions, instituted directly or indirectly by large public service corporations, have been sustained by the United States Supreme Court. Recent case, *Re Metropolitan Railway Receivership,* 208 U. S. 110 (1908).

The significance of the Wabash case has warranted extended discussion. Besides the cases cited in this note: *Chronicle,* vol. 38, p. 639; "A Chapter of Wabash," *North American Review,* vol. 146 (1888), p. 178; "The Wabash Receivership Case," *Am. Law Rev.,* vol. 21 (1887), p. 141. Also comments in Cleveland and Powell, *Railroad Finance,* etc., p. 235; Ripley, *Railroads,* etc., p. 385. See also note 20 of this article concerning friendly receiverships. For recent discussion, see *Some Legal Phases,* etc., p. 85.

18 Interesting recent case, *Farm. Loan & Trust Co.* v. *Meridian Water Co.,* 139 Fed. 661 (1905).

19 *Hollis* v. *Brierfield Coal and Iron Co.,* 150 U. S. 371 (1893) and recently *Guaranty Trust Co.* v. *Inter. Steam Pump Co.,* 231 Fed. 594 (1916).

20 In the words of the late Adrian H. Joline: Apparently well established principles of law, based on economic and social expediency, "enable every company in difficulties, which can find a non-resident creditor, willing to act, to place itself in the possession of a federal court receiver whenever it pleases."—Lecture of April 4, 1910, Harvard School of Business Administration.

In many instances minority interests have sought to set aside consent receiverships on the ground of dishonest collusion. For illustration, when the Philadelphia and Reading Railroad had failed in 1893, after riotous speculation by the president, this same president was appointed one of the receivers. The junior bondholders petitioned the court saying the ("friendly") creditor "did not file his bill in good faith on his own behalf and on behalf of all other holders of bonds, but at the request and for the benefit and protection of the men who were then managers of the Philadelphia and Reading Railroad Company and the Philadelphia and Reading Coal and Iron Company, and that the suit was not being pressed with due diligence."—*Ry. Age,* vol. 18, p. 735.

One of the most barefaced admissions on the part of a railroad management of the prostitution of court procedure to private ends is afforded by a statement to the stockholders of the Eastern Ohio Traction Company (dated February 15, 1904): "the appointment of a receiver is only a friendly arrangement, intended to facilitate plans for reorganization, which when accomplished will increase earning capacity."—*Chronicle,* vol. 78, p. 768.

In one or two rare instances the "friendly" receiver appointed on the petition of the corporation itself has been interpreted more as an agent of the corporation, under the protection of the court, than as an officer of the court; ("it is but just that a receiver so appointed should be held to be the corporation's

ditions, the usual practice in the consent receiverships may be very briefly stated. The necessity or desirability of a receivership having been agreed upon by the directors (usually in a secret meeting),[21] some friendly general creditor, with a claim in excess of three thousand dollars, not residing in the same state as that

agent."—*Texas and Pacific Ry. Co.* v. *Gay,* 86 Tex. 571. This is probably not good law, as a receiver under whatever conditions appointed "derives his authority from the court and not from the parties at whose instance he is appointed. He acts in behalf of no particular interest, but guards the rights of all" (198 Fed. 728). "The utmost effect of his appointment is to put the property from that time into his custody as an officer of the court" (136 U. S. 236). Quoted, approvingly, by Chief Justice Fuller, 145 U. S. 97. And the absolute neutrality of the receiver as an agent of the court is justified by a long line of Supreme Court decisions, 14 How. 52, 14 How. 368, 17 How. 322, 136 U. S. 223, 136 U. S. 87, 149 U. S. 473, 208 U. S. 360.

The history of the whole subject of consent receiverships can be followed from a few leading cases: *Meyer* v. *Johnston,* 53 Ala. 264 (1875); *Wallace* v. *Loomis,* 97 U. S. 146 (1877); *Wabash, St. Louis & Pacific Ry. Co.* v. *Central Trust Co.,* 22 Fed. 138 (1884); *Morgan's R. R. and Steam Co.* v. *Texas Central Ry.,* 137 U. S. 171 (1890); *Quincy R. R.* v. *Humphreys,* 145 U. S. 82 (1892); *St. Joseph and St. Louis R. R.* v. *Humphreys,* 145 U. S. 113 (1892); *Hollins* v. *Brierfield C. & I. Co.,* 150 U. S. 371 (1893); *Cen. Trust Co.* v. *McGeorge,* 151 U. S. 129 (1894); *Compton* v. *Jessup,* 68 Fed. 263 (1895); *Continental Trust Co.* v. *Toledo, St. Louis & K. C. R. Co.,* 82 Fed. 642 (1897); *Chapman* v. *Atlantic Trust Co.,* 119 Fed. 257 (1902), 145 Fed. 820 (1906), 208 U. S. 360 (1908); *Dickerman* v. *Northern Trust Co.,* 176 U. S. 181 (1900); *Great Western Mining Co.* v. *Harris,* 198 U. S. 561 (1905); *Blair* v. *Chicago,* 201 U. S. 400 (1906); *Horn* v. *Pere Marquette Ry. Co.,* 151 Fed. 626 (1907); *Wabash Rd.* v. *Adelbert College,* 208 U. S. 38 (1908); *Re Metropolitan Ry. Receivership,* 208 U. S. 90 (1908).

The general subject of consent receiverships has been the subject of numerous critical articles: M. M. Cohn, "Railroad Receiverships," *Am. Law Rev.,* vol. 19 (1885), p. 400; W. H. Bartol, "The Danger of Friendly Receiverships," *Popular Science Monthly,* vol. 32 (1887), p. 236; H. Woolman, "The Bane of Friendly Receiverships," *N. Am. Rev.,* vol. 158 (1894), p. 250; H. C. Caldwell, "Railway Receiverships in Federal Courts," *Am. Law Rev.,* vol. 30, p. 161; Chamberlain, "New-fashioned Receiverships," *Harvard Law Rev.,* vol. X, p. 139; editorial, *Bradstreets,* Jan., 1894.

21 The receivers for the old New York and New England Railroad were obtained at 2 o'clock in the morning for fear that attachments would be placed on the company's property the following day.—*Chronicle,* vol. 38, p. 30.

The receivership proceedings of the Chicago, Rock Island and Pacific Railway, in April, 1915, came suddenly and as a distinct shock to the business community. The contemplated action was known apparently only to the inner circle of directors, one director going so far as to say that he had been unaware that a receivership was being considered. There had been manipulation of the price of the stock immediately before the receivership, and the price declined abruptly immediately thereafter.

in which the railroad has its main office,[22] is asked to allow his name to be used in the receivership proceedings. Accordingly the attorneys for the corporation prepare the necessary bill of complaint to which the creditor complacently signs his name. The attorneys, at the same time, prepare the corporation's answer which admits the allegations of the creditor's bill and prays for the appointment of a receiver.[23] The court grants the prayer and appoints one or more receivers. Subsequently, the trustee of the general junior mortgage brings a foreclosure bill in the court of primary jurisdiction and the same receivers are appointed as under the creditor's bill.[24] At least one receiver is one of the old operating officials of the road, familiar with routine administration,[25] whose name is suggested to the court at the time.[26] The other

22 This precaution is necessary in order to throw the corporation into the federal courts. If it is desired to have the receivership in the state courts a resident creditor is selected.

23 This is called the primary bill. Ancillary bills are filed in every judicial district in which the corporation owns property.—Early leading case, *Booth* v. *Clark,* 17 How. 322 (1854). These ancillary bills must be counterparts, in all important particulars, of the original bill—*Merch. Trust Co.* v. *Kanawha and Ohio Ry.,* 39 Fed. 337 (1889)—and further state that the court of primary jurisdiction has appointed receivers.

24 Ordinarily the receivers appointed by the court of primary jurisdiction are respected by other courts, and this court will retain its control to the end of the controversy.—High, *Receivers,* p. 73; *Muller* v. *Dows,* 94 U. S. 444 (1876). As a result of the tangle over the receiverships following the last failure of the Northern Pacific Railroad, four justices of the Supreme Court declared that the suit should be "commenced in the circuit court of the district in which the principal operating offices are situated and in which there is some material part of the railroad."—*Farmers' Loan & Trust Co.* v. *Northern Pacific Ry. Co.,* 72 Fed. 26 (1896). See Daggett, p. 298; *Some Legal Phases,* etc., pp. 90, 157.

25 The only statistical study of the relative frequency of such appointments, that has come to my attention is that of Swain. He considers approximately 150 receiverships, from 1867 to 1897. These covered the following appointments: old presidents, 80 cases; general managers, 25 cases; superintendents, 17 cases; vice-presidents, 16 cases.

26 Sterne, an astute student of railroad finance, remarked many years ago: "A railroad official, in consequence of his incapacity or misfortune, or as the victim of a vicious system . . . is appointed receiver by the courts . . . and continues to earn probably a larger salary than he did as president. . . . This evil is a monstrous one."—S. Sterne, "Recent Railroad Failures and their Lessons," *Forum,* vol. 17 (1894), p. 31.

Ripley remarked, twenty years later: "The anomaly of rehabilitation entrusted to the very same persons who had brought about the failure is difficult to defend."—*Railroads,* etc., p. 387.

In Re Metropolitan Railway Receivership, 208 U. S. 90 (1908) the Supreme

receiver is a lawyer or publicist in whom the court has explicit confidence.[27]

Practically the first important work for the receivers to perform is the determination of relative priority of various claims and obligations of the bankrupt railroad. This is a problem requiring delicate judgment.[28] The natural assumption, in accordance with the *wording* of the railroad mortgages, is that the holders of bonds issued under these mortgages have a prior lien on the assets of the bankrupt corporation under all circumstances. But the courts have not so ruled. As far back as 1859, a federal court directed that the receiver meet the debts of employees before paying the interest on bonds.[29] The court alleged the well-being of the public

Court sought to absolve the equity courts from any accusation of collusion. But the reasoning hides an obvious fact behind legal verbiage.

27 Thus in the receivership of the Chicago, Rock Island and Pacific Railway (April, 1915) Judge Carpenter of the Federal Court appointed two receivers. One was H. U. Mudge, former president of the road and an appointee of the Reid-Moore group of speculators, who were responsible for the misfortunes of the road; and the other was J. M. Dickinson, a distinguished publicist, in whom the court had justifiable confidence. The decree provided that Mr. Dickinson should have the deciding voice in case of any difference of opinion.

28 In the larger reorganizations of the middle nineties the floating debt was almost always in excess of $10,000,000. Thus the Atchison, Topeka and Santa Fé had at its failure in 1893 over $10,000,000 of floating debt; so also had the Northern Pacific at the time of its failure in the same year. That of the Baltimore and Ohio was over $16,000,000, which amount was augmented by some $10,000,000 before a plan of reorganization was carried through. The floating debt of the Reading at the time of its last failure was estimated at over $25,000,000. (Daggett, p. 139.) Such large amounts as these necessarily represent perplexing problems, especially as the exact status of various parts of the floating debt with respect to each other and the issues of bonds is usually difficult to determine. (In the Norfolk and Western Railroad failure in 1893 there was over $300,000 of wage claims alone remaining unpaid.)

If the debt is secured by definite physical property of a stable value like steel rails, or ties, its position is secured, and actual money must be obtained immediately to meet it even though the court feels compelled to issue receivers-certificates, which may take precedence over the bonded debt. But, aside from these claims secured by the pledge of special property, the receiver ordinarily finds a great number of unsecured debts, inherited from the previous period of storm and stress. Moreover, the roadbed and equipment are probably dilapidated, and efficient operation—even public safety—may require immediate expenditures for the mere operation of the road. In this position the receiver appeals to the court to ascertain what old debts he must pay and what new ones he may contract. The answer to this problem has afforded one of the most difficult problems in the law of American railway receivership.

29 *American Railroad Journal,* vol. 15, pp. 475, 598 (Central Ohio, Steubensville and Indiana case).

as an excuse. Gradually, the same view was extended to other debts incurred in the actual operations of the road, on the ground that in no other way could the road render the required service to the public.

During a series of important decisions,[30] the United States Supreme Court gradually advanced to the formulation of a doctrine since known as the rule in *Fosdick* v. *Schall.*[31] This rule is based on two rather significant postulates. There is first a distinction made between the fundamental property or capital of the railroad and its current property in the form of current income; and there is also a distinction made between those current debts contracted to meet imperative operating expenses and those contracted for extraordinary expenses and improvements not absolutely necessary to maintain the road's operation. The Rule in *Fosdick* v. *Schall* permitted a court to insist that its receiver meet all his current expenses during the receivership before he should use any current income to meet the charges on capital—bond interest, rentals, and the like. It also provided that if any of the current income, in the period prior to the receivership, had been deflected from its proper and necessary use of meeting imperative operating expenses, to meet capital charges, then to that extent might the receiver give those necessary imperative operating expenses remaining unpaid a priority over the lien of mortgage bonds.

Since the rule in *Fosdick* v. *Schall* was laid down the federal and supreme courts have shown no uniformity in interpreting it.[32] One current of opinion set in toward a total extinction of the presumptive rights of mortgage bondholders, and the other toward the limitation of the priorities of current debts.[33] The whole matter

[30] 11 Wall. 459 (1870); 91 U. S. 603 (1875); 94 U. S. 798 (1876); 97 U. S. 146 (1878).

[31] *Fosdick* v. *Schall,* 99 U. S. 235, decided March, 1879. This leading case will be discussed in the immediately following notes.

[32] As one legal writer expressed it: "The decisions of the Federal Circuit Courts have reflected the uncertainty of the Supreme Court, and the fate of each claim has depended to quite an extent on the ideas of the judge who happened to be sitting in the case."—C. A. Dickson, "Rights of Material and Supply Men in Railroad Foreclosure," *Am. Law Rev.,* vol. 30 (1896), p. 529.

[33] The first tendency is shown by the Supreme Court in *Hale* v. *Frost,* 99 U. S. 389 (1879), *Burnham* v. *Bowen,* 111 U. S. 776 (1884), and *St. Louis R. R.* v. *Cleveland Ry.,* 125 U. S. 658 (1887). In the Burnham case, the acts of a receiver in paying old debts, even though there was no evidence that the corporation had deflected current income to capital charges, was confirmed. Rely-

seemed to turn on a balance between two conflicting sets of motives in the minds of the courts. On the one side are the motives of fairness to labor, small contractors, farmers who supply ties, and such creditors who may not be supposed to investigate the general credit of the railroad, but whose services and supplies must be

ing on these and similar decisions, certain of the federal courts, charged with the administration of the receiverships of the middle nineties, sought to emasculate entirely the lien of the mortgage bondholders. The extremes are probably represented by Judges Hanford and Caldwell. The former, in the litigation growing out of the Northern Pacific receivership, asserted "that he who takes a mortgage on a railroad does so with the knowledge that the railroad must be operated, and that its earnings must, so far as necessary, be absorbed in the payment of operating expenses."—*F. L. & T. Co.* v. *Nor. P. R.R. Co.,* 71 Fed. 246. Judge Caldwell, in one important opinion (*Farmers L. & T. Co.* v. *Kan. City W. and N. R.R.,* 53 Fed. 182), went so far as to give practically all current debts a priority in the capital estate of the corporation. He justified his attitude in a notable address before the Greenleaf Law Club of St. Louis (*Am. Law Rev.,* vol. 30, p. 161) on the ground that there is sometimes collusion between the stockholder-management of the railroad and its bondholders, citing the famous Memphis and Little Rock case (20 Fed. 260). This attitude is argued at length in an elaborate note by M. M. Cohn, 53 Fed. 192. Also *Ames* v. *Union Pac. Ry.,* 74 Fed. 335 (1896).

The opposite, more conservative current of judicial opinion, served to limit the scope of the rule in *Fosdick* v. *Schall.* In the Miltenberger case (called by Supreme Court Justice White "a leading case" in 197 U. S. 192), the Supreme Court stated that "the discretion (to give pre-existing debts a priority) should be exercised with very great care"—*Miltenberger* v. *Logansport Ry. Co.,* 106 U. S. 311 (1882)—and proceeded to limit specifically the priority claims. Noting, some eight years later, the extreme liberality with which certain federal court judges were wont to interpret the rule in *Fosdick* v. *Schall,* the Supreme Court said: "One holding a mortgage debt upon a railroad has the same right to demand and expect of the court respect for his vested and contracted priority as the holder of a mortgage on a farm or lot. . . . No one is bound to sell to a railroad company or to work for it, and whoever has dealings with a company whose property is mortgaged must be assumed to have dealt with it on the faith of its personal responsibility, and not in expectation of subsequently displacing the priority of its mortgage liens. . . . We emphasize this fact of the sacredness of contract liens for the reason that there seems to be growing an idea that the chancellor, in the exercise of his equitable powers, has unlimited discretion in this matter in the displacement of vested liens."—*Kneeland* v. *American Loan and Trust Co.,* 136 U. S. 97 (1890). And Chief Justice Fuller stated a little later, "We readily agree that the concession to a mortgagor company of the power through its own act to displace vested liens by unsecured claims is dangerous in the extreme."—*Quincy M. and P. R. R.* v. *Humphreys,* 145 U. S. 96 (1891). See also *Thompson* v. *Western Car Co.,* 149 U. S. 95 (1892); 71 Fed. 29 (1895).

During the time that the rule in *Fosdick* v. *Schall* was being interpreted by the courts, many magazine articles, legal notes and discussions appeared, all

furnished, regularly and liberally, in order to insure uninterrupted operation. Coupled with this is the imperative public necessity of operation, a necessity which the public character of the railroad business places ahead of the merely private property rights of stockholders and bondholders. On the other side lies the respect which the courts must extend toward contracts, especially those resting on a mortgage of specific property.[34]

In the application of the rule in *Fosdick* v. *Schall* to concrete cases, two insistent practical problems are presented: what are necessary operating expenses, and over how long a period before the receivership shall the priority order be extended. A long series of cases decided in the Supreme Court presents somewhat conflicting opinions as to what constitute necessary current operating expenses.[35] In two important decisions, the courts have

concerned with the justice and expediency of superimposing current expense debts over mortgage liens. The best unbiased treatment is C. A. Dickson, "Rights of Material and Supply Men in Railroad Foreclosures," *Am. Law. Rev.*, vol. 30, p. 520. A less comprehensive treatment with less apparent insight is L. S. Metcalfe, Jr., "Priority Over Mortgage of Debts Contracted by Railroads before Receiverships," *Cen. Law Journ.*, vol. 39 (1894), p. 241. An early statement, now of little value, is G. T. Bispham, "Rights of Material Men and Employees," *Am. Bar. Assn. Rep.*, vol. 3 (1880), p. 167, which aims to show the danger of the rule in *Fosdick* v. *Schall*, then being established. S. D. Thompson, "The Court Management of Railroads," *Am. Law Rev.*, vol. 27 (1893), p. 481, takes the same point of view in a polemic against the management of railroads by the court. There was an elaborate legal note by M. M. Cohn, covering the subject, 53 Fed. 182. Note also on the subject in *St. Louis T. Co.* v. *Riley*, 70 Fed. 32 (1895).

34 A summary of the present attitude of practicing reorganization attorneys is given by Byrne in *Some Legal Phases*, etc., p. 123.

35 The Supreme Court has specifically defined current operating debts as "debts not contracted upon the personal credit of the Company but to keep the road itself in condition to be used with reasonable safety for the transportation of persons and property, and with the expectation of the parties that it is to be met out of the current receipts of the company."—*Sou. Ry. Co.* v. *Carnegie Steel Co.*, 176 U. S. 285 (1900). Such current necessary expenses do not now include the costs of betterments, no matter how desirable.

Originally, the rule in *Fosdick* v. *Schall* (99 U. S. 235) was worded "necessary operating and managing expenses, proper equipment and useful improvements." But "useful improvements" were subsequently denied in the lower courts (1909). *Ill. T. and S. B.* v. *Doud*, 105 Fed. 123 (1900) and *Rhode Island Loc. W.* v. *C. T. Co.*, 108 Fed. 5 (1900). And in the Supreme Court—*Wood* v. *Guaranty T. Co.*, 128 U. S. 416 (1888). Even a debt for rails "imperatively required in order that the road may be safely used for transportation of persons and property" was denied priority on the ground that the quantity of rails was so large as to constitute a reconstruction of the road.—*Lackawanna*

tried to define specifically the current debts that could claim priority. These are the debts for labor, the unpaid balances for current expenses due, connecting roads,[39] and materials for such maintenance as must be "done before the road can be occupied or used," not . . . "to replace old or worn-out counterparts.[37] In other words, debts for services and materials without which the established routine operation of the road would stop.[38] The other practical question in this connection is the age of the claims. All decisions admit that if a merchandise creditor has allowed his account to remain uncollected for a considerable period, he must be presumed to be depending on the general credit of the road. The debt, no matter of what character, is therefore not entitled to any priority. But the exact period of grace has been left to the judges of the federal courts appointing the receivers, and the Supreme Court has confirmed their decisions whenever the particular facts show them to have been reasonable and just.[39] A period of six months has been explicitly approved by the Supreme Court in a comparatively recent decision[40] and has been quite generally adopted as a working principle by the federal courts of the East or Middle West.[41]

Iron and Coal Co. v. *F. L. & T. Co.,* 176 U. S. 298 (1900). The Supreme Court has even denied the priority of a debt for new ties to replace decayed ties, on the ground that the road could somehow operate with the old ties—*Gregg* v. *Metro. Trust Co.,* 197 U. S. 183 (1905). It should be noted, however, that this latter case, the Grègg case, has the force of this extreme position somewhat weakened by the dissent of three of the justices on the ground of public policy.

36 *Miltenberger* v. *Logansport Ry. Co.,* 106 U. S. 286 (1882).

37 *Clev. C. and S.* v. *Knickerbocker T. Co.,* 86 Fed. 73 (1898).

38 For more extended discussion of the preferred claims in the various cases mentioned in the three preceding notes, see particularly the Miltenberger and Gregg cases, cited above. The strict and liberal interpretations are clearly contrasted in the prevailing and dissenting opinions of the latter case. See also Macken, *Modern Law of Corporations,* 564.

39 It is impossible to state definitely any arbitrary rule. In one case the Supreme Court approved a limit of three months.—*Miltenberger* v. *Logansport Ry. Co.,* 106 U. S. 325 (1882). Justice White later called this the leading case dealing with the preference of different claimants (197 U. S. 192), while another court allowed a debt of nearly two years to have preference over bonded debt.—*Atkins* v. *Ry. Co.,* 3 Hughes C. C. 307. See also *N. P. R. R.* v. *Lamont,* 69 Fed. 23 (1895). Note on time fixed in different decisions prior to 1884, 22 Fed. 476.

40 *Gregg* v. *Metro. Trust Co.,* 197 U. S. 183 (1905).

41 See note, High, *Receivers,* p. 512, stating courts which have and have not accepted the six months' limit. The "six months rule" is accepted by eastern state courts. For example, "the usual rule is to allow prior claims for materials

Closely allied with the question of the priority of current debts is that of the right of receivers to issue receivers-certificates to take precedence over the preëxisting general creditors[42] or even the mortgage bondholders.[43] Here too the law is by no means clear. The receiver asks of the court permission to issue certificates. In this petition he must designate in considerable detail the purposes for which he wishes to use the proceeds obtained from their sale; yet the general purposes for which receivers-certificates may be issued have never been definitely defined by the courts.[44] But it may be said that the courts are willing to permit the receiver to issue his certificates without much question and to any reasonable amount, if it appears that the interest and principal can be met from the current earnings of the road, or if the bond-

and labor for the six months preceding the appointment of a receiver."—*Rutherford* v. *Penn. Mid. R.R.*, 178 Penn 42 (1896). Judge Caldwell asserted explicitly there was no six months limit.—*Far. L. & T. Co.* v. *Kan. City. Ry. Co.*, 53 Fed. 182 (1892). The Supreme Court has stated that the six months rule did justice ordinarily, but that older claims might be given priority in unusual circumstances.—*Southern Ry. Co.* v. *Carnegie Steel Co.*, 176 U. S. 285 (1900).

42 Receivers-certificates may be even given priority over the claims for current operating expenses under the rule in *Fosdick* v. *Schall.*—*Bank of Commerce* v. *Cent. Coal and C. Co.*, 115 Fed. 878 (1902).

43 The priority of the certificates, unless expressly limited by the court, reaches under any debts contracted by the road. See 13 Atl. Rep. 271; also *Ames.* v. *Union Pac. Ry.*, 74 Fed. 335 (1896). But if the receiver was appointed at the request of certain junior mortgage bondholders, he would not ordinarily be permitted to issue receivers-certificates having a lien pior to a senior mortgage. See a series of discussions in the federal courts, by no means uniform, 54 Fed. 556 (1893); 62 Fed. 771 (1894); 71 Fed. 776 (1896); 79 Fed. 196 (1897); 102 Fed. 382 (1900). The matter is by no means clear, as a liberal interpretation of the priority of operating expenses—even before the receivership—as laid down by the Supreme Court in the rule *Fosdick* v. *Schall,* and interpreted in the Illinois Midland case—*Union Trust Co.* v. *Illinois Midland R.R. Co.*, 117 U. S. 434 (1886)—would seem to give the court unlimited power in the issue of receivers-certificates. Also *Amer. Trust Co.* v. *Metro. Steamship Co.*, 183 Fed. 250 (1910); and 190 Fed. 113 (1911); *Atlantic Trust Co.* v. *Chapman,* 208 U. S. 360 (1908). In actual practice, the court tries to be precise in defining the priority of the receivers-certificates it authorizes. For references to a number of instances of liberal use of receivers-certificates, see Cleveland and Powell, *Railroad Finance*, p. 243.

44 The mere appointment of the receiver does not empower him with the court's authority to borrow on receivers-certificates. Nor does the assumption by the receiver that the court will permit him to borrow give the borrowings a priority over other forms of indebtedness. For discussions see the leading Illinois Midland case, 117 U. S. 434 (1886) and other cases cited in preceding note.

holders consent to their issue.[45] Certificates may even be issued if they infringe on the actual capital of the railroad property—even to the point of cutting under prior lien mortgages[46] provided it is necessary to obtain money for the preservation and operation of the property.[47] They may also be issued to meet the debts for labor and necessary materials during the period just prior to the receivership,[48] although such certificates may not have the same priority as those issued to pay the debts of the receivership.[49] When this liberality of issue is carried to an extreme, courts of equity may so burden a railroad with receivers-certificates that the value of the mortgage bondholder's lien is absolutely obliterated. In several recent instances, this has been exactly what has happened, and the bondholders have had nothing of real value left when the time came to discharge the receiver. It is this power of the courts of equity, supported by a series of Supreme Court decisions,[50] that jeopardizes both the spirit and the letter of rail-

[45] *Rutherford* v. *Penn. Midland R.R.,* 178 Penn. 38 (1896). Pennsylvania Supreme Court permitted issue of receivers-certificates to complete line at "the request of a very large proportion of bondholders, and without prejudice to the non-assenting."

[46] Leading case *Wallace* v. *Loomis,* 97 U. S. 146 (1878); *Union Trust Co.* v. *Illinois Midland R.R. Co.,* 117 U. S. 434 (1886). For comments on this doctrine see *Kneeland* v. *Am. L. & T. Co.,* 136 U. S. 89 (1889).

[47] On November 2, 1917, the bondholders' committee of the Gulf, Florida and Alabama Railway urged the depositing bondholders to accept a rather drastic reorganization plan which revealed an interesting case of the gradual emasculation of the bondholders' lien by a receiver. It appeared that $500,000 of receivers-certificates had been given by the court a lien ahead of $4,000,000 first mortgage bonds. "Of these only $222,500 had actually been sold and the proceeds used largely to satisfy lien claims incurred previous to the receivership, and for operating deficits." The remainder could not be sold, and there was an operating deficit of $10,000 per month; "so that a debt is piling up prior to the bonds which must be stopped at once to preserve any value in the bonds."

[48] *Union Trust Co.* v. *Illinois Midland R. Co.,* 117 U. S. 434 (1886).

Apparently the court must be convinced that the materials and services are required for the actual operation—necessary operating expenses as defined in the earlier part of this article.—(*Rogers B. C. Co.* v. *Omaha K. C. E. R. R.,* 154 Fed. 629, 1907)—and would frown upon allowing the expenses of extraordinary replacements and betterments to be paid out of the proceeds of receivers-certificates. It should be noted, however, that the distinction will depend upon the theories of railroad accounting and the standards of operating efficiency adopted by the courts.

[49] *B. of C.* v. *Cent. C. & C. Co.,* 115 Fed. 878.

[50] *Am. B. Co.* v. *Heidelbach* 94 U. S. 798 (1876); *Wallace* v. *Loomis,* 97 U. S. 146 (1878); *Fosdick* v. *Schall,* 99 U. S. 235 (1879); *Swann* v. *Clark,* 110 U. S. 602 (1883); *Union Trust Co.* v. *Illinois Midland R.R. Co.,* 117 U. S. 434 (1885).

road mortgages. The possible exercise of this power by the federal courts weakens every public utility bond. It has been called the "extreme limit of the most extraordinary powers of a court of chancery."[51] The present writer would prefer to call it an unjustifiable emasculation of the substance of presumably inviolable contracts.

During the period that the receivers are working out these and other detailed problems of the actual management of the railroad, the various committees are at work seeking to find a substantial basis upon which to establish their plan of reorganization.[52] This requires a knowledge of at least five sets of facts. First, they must ascertain by competent auditors whether or not the published reports of the railway in the years preceding the failure were approximately true. The audit must not only verify the technical correctness of the books, but it must also determine whether or not the depreciation accounts were adequate, and if they were not—as was probably the case—to what extent the reserves were inadequate. The auditors must also ascertain whether or not all the rolling stock, claimed by the road to be in fit "usable" condition, was actually in use or in fit condition; they must check all the rentals, insurance policies and intercompany contracts to be sure that the old managers had protected the company's contractual rights. The second set of facts is supplied by special traffic accountants working independently or in collaboration with the auditors. It involves a nice determination of the relative and absolute earning capacity of the various parts of the railway system. This is important because only by classifying the subsidiary lines and leased lines according to their past earning capacity can the reorganization committees determine what parts of the system to retain in the subsequent reorganization and what parts to surrender.[53] The third set of facts is supplied by engi-

51 Machen, *Modern Laws of Corporation,* Sec. 2049.

52 It is becoming the custom in large railway reorganizations for the receivers not "to concern themselves with plans for reorganization." Quotation from Judge Lacombe, *Penn. Steel Co.* v. *N. Y. City Ry.,* 157 Fed. 442 (1907).

53 In the earlier reorganizations this classification, if any were made, was more or less a matter of guess work. In the Wabash reorganization of 1887, all subsidiary parts were retained and approximately equal sacrifices enforced on all the branch line bondholders. In the Atchison reorganization of 1888, there was no attempt to separate the subsidiaries according to earning power. But in the Norfolk and Western reorganization of 1896 and in the voluntary reorganization of the Baltimore and Ohio in 1899 there was a "guesswork" attempt to apportion the sacrifices of the branch line bondholders according

neers. They consist of a careful summary of those expenditures which must be made in the immediate future and those which are to be recommended in order to increase materially the future earning capacity of the road. The committee must know these facts in order to estimate the amount of new money to be provided in the reorganization. A fourth set of facts are supplied by attorneys, acting for the reorganization committee. They have to do with the countless legal matters resulting from the general tangle: what contracts may be safely abrogated and what contracts must be fulfilled even at temporary losses, the amounts required to settle with parties holding contingent claims in order to forestall troublesome delays, the probable outcome of pending suits and the approximate expenses of the receivership and reorganization. A fifth set of facts the reorganization committees must supply themselves, and since there are among their number distinguished bankers they require no independent expert advice. These facts cover the general probability for the successful negotiation and sale of the securities of the reorganized road. The committee must assess accurately the probable effect of their reorganization plan on the market values of old and new securities, the limit of sacrifice stockholders will make without surrendering their interests, the relative marketability of long and short-term bonds, underwriting commissions and similar financial matters. Out of the shreds of these, and perhaps countless other facts, the reorganization committee must weave the pattern of its reorganization plan.

In all this work of preparation of the final reorganization plan, the receivers of the road are not considered.[54] But they report

to the probable relative earnings of the branches. In both the St. Louis and San Francisco, and Missouri Pacific reorganizations in 1916 and 1917 efforts were made by the general reorganization committees to determine the actual earning capacity of the subsidiary and branch lines and to apportion the sacrifices accordingly. The committees reached their findings with the help of elaborate reports by engineers, accountants and traffic experts.

During the receivership of the Bay State Street Railway in 1918, accountants classified the unprofitable branch lines as: (1) Those which would pay, provided there was a reasonable increase in fare; (2) those which would pay provided there was a reasonable increase of fare and substantial subsidies from the local towns; (3) those which would not pay under any reasonable conditions.

54 Meade, writing in 1901, after the railroad reorganizations of the nineties, states: "The receivers or the directors may themselves formulate a plan of reorganization, or they may appoint a committee to formulate such a plan,

continually to the court the results of their administration of the railroad property. From these reports the reorganization committees can form estimates of the current earning capacity of the road. They can also judge when the time is ripe to bring forth their reorganization plan. Formerly plans were propounded by one committee after another, beginning almost as soon as the rumors of the railroad's disaster.[55] But now it is the custom for the reorganization committees to wait until they have gathered a complement of information and until the earning capacity of the road, under the receivership, has been fully tested. During this time, the various committees adjust their differences on the basis of actual facts, so that finally, when the plan is announced, it will have received the acknowledged support of all the committees representing the conflicting interests.

In contrast to the reorganizations before 1900, it may therefore be said that the contemporary practice is to lengthen out the period of preliminary investigation and adjustment, during which time no reorganization plan is published, and, so far as possible, to shorten the period of public discussion over the plan through a preliminary agreement on the part of all the influential interests to support the final plan as soon as it is published. Practically all the recent reorganizations have run along smoothly in an orderly manner to outward appearances. The Chicago, Rock Island and Pacific, the St. Louis and San Francisco, the Pere Marquette —all of them reorganizations involving a multitude of conflicting interests—were consummated without apparent external friction once a definite and final plan had been agreed to secretly by the various committees representing important securities.

To secure this harmony of interests, working for the success of a common plan, is the most important and the most difficult step

to which they invite the assent of the security holders."—E. S. Meade, "The Reorganization of Railroads," *Am. Acad.*, vol 210 (1901), p. 210. This assertion has now little significance, even if it had twenty years ago. The tendency is for the receivers to concern themselves but little with the preparation of the plan, as courts are insisting that their receivers remain absolutely neutral in all questions likely to cause controversy among the various security holders.

55 For example, there were no less than seventeen separate plans advanced in connection with the three reorganizations of the Philadelphia and Reading Railroad reorganization of 1882-6 plans; reorganization of 1886-7 plans; reorganization of 1895-6 plans. An illuminating survey of the almost hopeless confusion of conflicting committees and conflicting plans in an old reorganization is given in Daggett's two chapters covering the three reorganizations of the Reading.—*Railroad Reorganizations.*

in the reorganization procedure. All, except perhaps the senior bondholders, must make some sacrifices. But the determining voice lies usually with the committee representing those securities—usually the junior mortgage bonds or debentures—of which some sacrifice is required, but which is, nevertheless, in a relatively secure position as compared with the holders of the floating debt and the stocks. In other words, the plan is likely to be determined by the faction making the least sacrifice.

Out of the conflict of opinions and interests, a plan of reorganization is finally evolved. Before the receiver surrenders the property, or even before the foreclosure sale,[56] this plan is published with the recommendation of all the committees that it be accepted by the various groups of security holders. The latter are asked to become parties to the "reorganization agreement," which is the formal legal document that invariably accompanies "the plan."[57] By so doing, they acquiesce to the terms of the

56 It is inexpedient for the members of the committee to take steps to secure the reorganization until after the plan has been announced, as no such action is usually provided for in the original deposit agreement, and an assumption of authority would be interpreted by the security holders, and even by the courts, as evidence of coercion. In one noted case the deposit agreement under which the reorganization committee acted provided that the committee could buy the railway property after it had announced a plan of reorganization. It bought the property before the announcement. The court decided this was a breach of contract, notwithstanding the very general powers granted the committee.—*Industrial,* etc. v. *Tod,* 180 N. Y. 215 (1905). In order to forestall obstructionists, Cravath advises that a foreclosure decree be obtained before the announcement of the plan; and permission so to do must be included in the original deposit agreements. On the other hand, any such procedure prevents any voluntary settlement among the security holders on the basis of an eminently fair and advantageous plan—as in the Baltimore and Ohio reorganization of 1899. There was one notable case, the Texas and Pacific reorganization of 1887, in which a voluntary adjustment with all the security holders was made after the foreclosure sale, so that the sale was never confirmed.

It is, however, necessary to note, in passing, in view of the Tod case above mentioned, that the reorganization committees must not overstep any of the authorities or limitations and restrictions specifically imposed upon them by the deposit agreements under which they are acting. See also *United Water Works Co.* v. *Omaha Water Co.,* 164 N. Y. 41 (1900).

57 Care should be taken to distinguish between the "reorganization plan" and the "reorganization agreement." The former is the short, comprehensive statement of the financial side of the reorganization; it is an easily understood document, free from legal verbiage and intended for wide distribution. The "reorganization agreement" is an elaborate legal document. It covers the details of the "plan," together with a full and presumably exhaustive statement of the powers and limitations of the committee or committees which will carry

reorganization, and on paying their assessment, if any is called for, receive their allotted securities in the new corporation. Those who do not care to accept the terms of the reorganization are allowed to withdraw the securities originally deposited,[58] usually on the payment of a small fee to cover the expenses of the committee. If, as is probably the case, a very large proportion of the security holders consent to the conditions, the reorganization committee declares the plan operative, and the reorganization is finished except for the legal formalities.[59]

These legal formalities are, however, often very perplexing, and depend largely on the attitude of the old security holders. If practically all the security holders accept the plan, surrendering their old stocks and bonds, then no pressure upon a recalcitrant minority need be exerted. There need be no judicial sale of the old corporation's property, and no surrender of its charter. This was what happened in the great reorganization of the Baltimore and Ohio Railroad in 1899. But a complete adjustment with all the claimants and security holders is usually impossible. Some persons will feel themselves aggrieved in any plan of reorganization, and there are always strikers—to be discussed presently—who will seek to impede the progress and try to create for themselves a nuisance value, in hopes that the reorganization managers will buy them off at some fictitious price. To carry out the obvious will of the great majority of assenting claimants and security holders, the reorganization must be forced through and the dissenting minority and obstructionists settled with in a just and open manner fully approved by the court.[60] This is accomplished by the judicial sale

out the "plan," the rights of the assenting security holders, and a detailed account of the machinery by which the reorganization will be consummated. P. D. Cravath writes an illuminating defense of the inordinate length of the modern reorganization agreement.—*Some Legal Phases,* etc., p. 176.

58 *Colonial Trust Co.* v. *Wallace,* 183 Fed. 897 (1910).

59 Ordinarily finished. By declaring the plan operative, the various contracts of security holders, syndicate subscribers, and debt claimants become binding. But, the plan may be subsequently modified—providing always that the modifications are acceptable to the contracting parties—and it may even be set aside entirely and a new plan adopted. Generally speaking, however, when the plan has been declared operative, it indicates that the main adjustments have been accomplished and only the loose ends remain unfinished. These may require considerable time, as the wheels of equity procedure move slowly, but to all outward intents and purposes the reorganization has been consummated.

60 The court, by approving of the conditions of the judicial sale, may indirectly force the dissenting minority to accept the plan of reorganization approved by the assent of an overwhelming majority. But the court cannot

of the old corporation's property through a decree of foreclosure.

In theory, at least, the foreclosure of a great railroad system is similar to that of the foreclosure of a mortgage on a house,[61] but in actual practice the courts tolerate the doctrine that the "foreclosure proceedings of mortgages covering extensive railroad properties are not necessarily conducted with the limitations that attend the foreclosure of ordinary mortgages."[62] In fact, it was recognized long ago that the court might arrange the formal steps in the foreclosure with a view to facilitating the execution of a plan of reorganization already agreed upon and, by implication, approved by the court.[63] If need be, it will even order a sale of the corporation's property before the status of different claimants is determined, on the assumption that the quicker the reorganization is carried out, the better will it be for all concerned.[64] Here, as elsewhere in this complicated subject, lies the general rule that the courts have sought to facilitate the adjustment of purely private dissensions with a view first of all to the larger questions of public policy. Judging from the words of perhaps the ablest student of reorganization, they have not abused this power.[65]

directly force a security holder to accept a plan. "It is clear that the courts cannot directly or indirectly rewrite this reorganization agreement."—*Guar. T.* v. *Inter. Steam Pump Co.,* 231 Fed. 595 (1916). This was tried in one notable case, but the United States Circuit Court of Appeals (Supreme Court Justice Brewer rendering the opinion) declared against any such use of the court's power on the ground that "there is no wide discretion vested in the chancellor which permits him to disturb contract rights—the rights of property . . . It is not for the court to assume the power to compel because it believes it wise and good business . . . Every man in this country decides questions in respect to his own property for himself."—*Merchants Loan and Trust Co.* v. *Chicago Rys. Co.,* 158 Fed. 923 (1907).

61 The trustee of one of the junior mortgages just above those underlying mortgages which are not to be disturbed in the reorganization, moves for a judicial sale of the corporate property of the railroad. This position is usually unopposed by the railroad. For details of procedure, see Byrne's essay entitled "Foreclosure of Railroad Mortgages" in *Some Legal Phases,* etc.

62 *Louisville Trust Co.* v. *Louisville, N. A. and C. Ry.,* 174 U. S. 682 (1899).

63 *Soye* v. *Cent. R.R. Co.,* 99 U. S. 334 (1878).

64 *First Nat. Bank* v. *Shedd,* 121 U. S. 74 (1886). See also *Alabama G. Co.* v. *Robinson,* 72 Fed. 708 (1896); *Guaranty Trust Co.* v. *Metro. Street Ry. Co.,* 168 Fed. 937 (1909) and 177 Fed. 925 (1910).

65 "It is a source of pride, or ought to be, to every lawyer and man of business, that as a rule our federal tribunals have so used their powers as to conserve the right of property and to bring about the greatest good to the greatest number regardless of mere technical rules."—Joline, *Lectures, Harvard School of Business Administration,* p. 83.

The next step is the "decree" of sale, according to which the court preserves the outward form of the fiction of a foreclosure sale.[66] Owing to the fact that the foreclosure of the property of a great railroad corporation requires far more capital than a single man or group of men can command, the court recognizes that there will be no competition at the foreclosure sale of the property. In order to prevent the various parties who have agreed among themselves upon a workable plan of reorganization from conspiring together to purchase the property for little, and thus defeat the just claims of other creditors who have not pooled their interests, the court ordinarily fixes a minimum or "upset" price.[67] It is the amount which the receivers must realize from the property in order that the court shall confirm the sale. It amounts, practically, to the determination by the court of the price at which the reorganization committee may acquire the property of the old corporation at a public sale, and indirectly to the conditions according to which the committee must settle with the creditors who have not consented to its plan. There is, theoretically at least, a chance that other persons may care to pay more for the property than the reorganization committee,[68] and the general creditors not embraced in the committee's plan should be given—theoretically at least—an opportunity to bid in the property in satisfaction of their own liens. Moreover, the public sale preserves the form of legal procedure required in the foreclosure of a mortgage on a plot of land. But it is a foregone conclusion that the only bidder will be a representative of the reorganization committee, and his bid will represent a few dollars more than the court's upset price.[69] Accordingly, in recent practice, many courts,[70] to save the expense and notoriety connected with a public sale, authorize the receivers to give notice that they propose to

66 For details, see *Some Legal Phases*, etc., p. 139.

67 Cravath, *ibid.*, p. 202.

68 Very seldom indeed is this chance realized. Cleveland and Powell cite the interesting example of the Cape Fear and Yadkin Railroad, which was bid in by the Atlantic Coast Line interests in opposition to the plan of the reorganization committee acting for the Seaboard Air Line Railway.—*Chronicle*, vol. 67, p. 1355.

69 As very succinctly stated by Byrne: "The railroad company is an empty shell; its bondholders, creditors and stockholders are going to be the purchasers and to be, with such people as agree with them to put fresh money into the property, the bondholders and stockholders of the new company which is to own the road after foreclosure sale."—*Some Legal Phases*, etc., p. 142.

70 Particularly those of New Jersey.

sell at private sale the property of the corporation to the reorganization committee in accordance with their preärranged plan. If any one objects, or can guarantee that a larger sum shall be obtained at a public offering, the court will authorize it. Ordinarily no one objects, and the plan is carried out at a distinct saving of expense.

If no upset price is fixed, or if it is very high, the bid obtained by the receiver may be less than what the court deems just. A second, or even third, sale may be ordered in the hope of obtaining more. Sooner or later, the sale is confirmed by the court and the property comes into the possession of the new owner; and, automatically, the administration of the receiver ceases.[71]

The most difficult problem remaining to the reorganization committee after the sale is that of the final adjustment of conflicting interests. In case all the bonds are of one class, are all deposited with the reorganization committee, and there exist no other creditors, the transition from control by the receivers to that of the new corporation occurs without a possibility of friction. But such simplicity is seldom present. There are always claims to be adjusted. If the upset price exceeds the face value of one or more issues of underlying bonds, these bonds are not affected; in the vocabulary of finance they are "undisturbed." If the upset price does not equal the face value of a bond issue some adjustment is necessary with those of the bondholders who have not consented to enter the reorganization, and some kind of settlement must also be made with other creditors who refuse to consent to the plan.

These active and latent objectors are called "strikers." They

[71] The only exhaustive study made of the relative lengths of receivership is that of a table compiled by Swain, published in 1898. Using this table, with certain interpolations and adjustments, it may be said that of the 610 railroad receiverships established prior to January 1, 1894, 110, or 18 per cent, lasted less than one year; 147, or 24 per cent, between one and two years; 115, or 19 per cent, between two and three years; 85, or 14 per cent, between three and four years; and the remainder, 153, or 25 per cent of the whole, lasted more than four years. Altogether, the average duration was two years, ten months.

The present writer is of the opinion, although he has compiled no statistics to prove it, that the length of railroad receivership has increased of late years. Prior to 1890 so many small roads passed into the hands of receivers, whose affairs could be easily adjusted, that the average period was less. Recently, however, owing to railroad consolidation, every receivership represents an intricate problem which requires a comparatively long time to solve. Moreover, the standards of efficiency are much higher than before 1893, and a court is reluctant to loosen its grasp on a railroad property until it is assured that permanently good service can be rendered the public.

are of two groups. There are the general creditors of the corporation, who have furnished it with labor and material before the failure and who, being relatively few in number, have neither organized nor otherwise intervened in the proceedings. They cannot be neglected, and provision is made that their claims may be paid entirely or partially out of the money subscribed at the time of the reorganization. In case they are not satisfied with the adjustment accorded them, one or more may begin legal proceedings to set aside the foreclosure sale or otherwise hinder the course of the reorganization. The legal standing of these general creditors is by no means clearly defined, but the leading Kansas City Southern case seems to countenance the theory that they may be ignored if the railroad property is worth less than the mortgage debt, but must be included in the reorganization if the property is worth more.[72]

The other class of strikers are the security holders who object

[72] In one notable case a general creditor was able, through a noteworthy decision of the Supreme Court to annul the work of the reorganization committee merely because an agreement had been reached—as is always the case—between the stockholders and the bondholders. The court seemed to assume that such an agreement looking toward the foreclosure of the corporate property by the stockholders and bondholders, no matter under what conditions, was likely to work harm to the excluded general creditor, because he is ordinarily not strong enough to defend himself against the combination of security holders. This was the famous Monon case.—*Louisville Trust Company* v. *Louisville, New Albany and Chicago Ry. Co.,* 174 U. S. 674 (1899). It has latterly been strengthened by the now equally famous Northern Pacific or Boyd case, in which the court allowed an unsettled judgment against the old Northern Pacific Railroad to be levied against the new, reorganized Northern Pacific Railway, on the ground that the reorganization plan made no provision for the unsecured creditors, although it permitted the old stockholders to retain an interest in the new railway company by the exchange of old shares for new.—*Nor. Pac. Rd. Co.* v. *Boyd,* 228 U. S. 482 (1913). "Any device," said the prevailing opinion of the Supreme Court, "whether by private contract or judicial sale under consent decree, whereby the stockholders were preferred before the creditor, was invalid" (504). For comprehensive account of the Boyd case, see Cravath, *Some Legal Phases,* etc., p. 191. On the other hand, a long series of legal decisions, based on the theory that the general creditors have the privilege of combining together and buying in the property, the same privileges possessed by other creditors, has given legal support to the machinery of reorganization and the final settlement with them on the basis of the arbitrary upset price determined by the court. For instance, in an opinion delivered by the Supreme Court soon after the Monon case, the legality of a sale of property to the reorganization committee was upheld even though the committee had promised to give the old stockholders an interest in the new corporation. The only question was this—Was the property worth more than the mortgage bonds? If it was, then the general creditor had an interest in

to the conditions of the plan or the general procedure connected with the sale of the property, or even the execution of the reorganization agreement.[73] Although not ordinarily powerful enough to reorganize the company in their own way, they are in a position to delay the reorganization by litigation. Sometimes these "strikers" have a real grievance. In the Philadelphia and Reading reorganization of 1887 the majority of a junior issue of bonds formulated a plan in opposition to that adopted, and agreed among themselves not to comply singly with the provisions of the operative plan. Ultimately the committee felt compelled to pay them the par value of their bonds.[74] There are speculators in New York who make it their business to "hold up" reorganization committees,

the equity; if it was not, then the general creditor had none. In the latter case, the mortgage bondholder could, if he chose, surrender some of his interest in the property to the stockholder—or anybody else—without defrauding the general creditor.—*Dickerman, Trustee,* v. *The Northern Trust Co.,* 176 U. S. 181 (1900). And in the rehearing of the Monon case, above referred to, this view was maintained by the federal court.—103 Fed. 110 (1900). And the theory may be regarded as generally accepted, in spite of the apparent anomalies of the Monon and Boyd decisions, that the foreclosing bondholders may do with the property as they like, provided there is no equity remaining to the general creditors from which they were fraudulently debarred.—*Kansas City Sou. Ry.* v. *Guardian Trust Co.,* 240 U. S. 166 (1916). Yet the courts very naturally scrutinize, with great care, a reorganization agreement in which the stockholders are admitted to an interest in the new company, if the old company's debts are not all paid. "Unquestionably the sale of a railroad property under foreclosure proceedings to a committee of reorganization, according to whose plan the stockholders of the mortgagor company appear to obtain some benefit in the purchasing company, is open to the closest scrutiny." —Joline, *Lectures,* p. 52. Any suggestion of fraud or coercion or apparent injustice will defeat the proceedings. "But where," in the words of the Chicago and Erie decision, "in ordinary course, foreclosure is instituted and carried out for the honest purpose only of enforcing against the property the mortgage obligation, the mere fact that shareholders of the old company may, under a purchasing arrangement, become interested in the securities of the new, will not make the foreclosure *per se* fraudulent. . . . We see no reason why the purchaser for reorganization may not include any one whom he chooses to take into the organization, and may not contemplate even an exchange of some of the new securities for outstanding shares. To the extent that the property is worth something more than the mortgages, the general creditors are interested in any subsequent distribution. But beyond that, their interest does not extend."—*Wenger* v. *Chicago and Erie Railway Company,* 114 Fed. 34 (1902).

73 See Cravath, *Some Legal Phases,* etc., p. 202 ff.

74 It should be noted, however, that the committee was anxious to effect the reorganization without foreclosure proceedings, as there were reasons to suppose that the old charter was valuable and should be preserved. Had the committee been willing to foreclose, this "settlement" would have been unnecessary.

and such is the impatience of business men, such the possible delays in litigation, and such the expenses of a prolonged receivership, that "strikers" are ordinarily bought off. This practice only aggravates the evil. One man in particular has obtained an unenviable reputation by his numerous exploits. The fact remains that, in spite of questions of ultimate justice, in a field where justice is necessarily tempered by expediency, the effort of a few to exact onerous terms from a majority by using or threatening to use the courts for purposes of delay, can hardly justify itself, whatsoever the plea.[75]

As soon as the various conflicting interests are adjusted—in the majority of cases even before final settlements are reached—the reorganization committee causes a new corporation to be formed. The same name is retained, except that railroad is changed to railway, or company to corporation.[76] In due course of time, the assets bought at the receivers' sale are transferred to the new corporation.[77] The reorganization is completed.

ARTHUR S. DEWING.

75 The late Adrian H. Joline put the matter well when he said: "I confess that I have a most profound contempt for most of these "bona fide holders" who try to block reorganizations; usually I could name two or three men who are responsible for these blackmailing enterprises. . . . I speak of this, because I want to impress upon you that almost all the outcry against reorganization methods comes from people who are only insincere, selfish speculators, without any genuine interest in the business, hanging on the outskirts of these enterprises in the hope of picking up some fragments."—*Lectures,* p. 86.

76 This is the commonest subterfuge. It is worked back and forth. First there was the St. Louis and San Francisco Railway. It became the Railroad, through reorganization, in 1896, and again the Railway in 1916. Infrequently there is a slight transposition in the title itself, as when the Battle Creek and Bay City Railway became the Bay City and Battle Creek Railway after a reorganization in 1889.

The Memphis and Little Rock Railroad was sold at foreclosure sale and became the Railway. This was foreclosed a second time and became the Little Rock and Memphis Railroad. It was foreclosed a third time and became the Railway.—*Am. Law Rev.,* vol. 30, p. 161; 20 Fed. 260.

77 The strict law is that the acquiring company is in no wise liable for debts or other obligation created by the receiver while managing the corporation.—*Godfrey* v. *Ohio and M. Ry. Co.,* 116 Ind. 30 (1888); *Davis* v. *Duncan,* 19 Fed. 477 (1884); also 67 Fed. 456 (1895); 71 Fed. 636 (1895); and 83 Tex. 286 (1892). But where the receiver has improved the property and returns it to the stockholders more valuable than when he received it, the court, in confirming the restitution, may require that the corporation assume the liabilities incurred by the receiver.—*Balt. R.R. Co.* v. *Buris,* 111 Fed. 882.